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In The  
**Supreme Court of the United States**  
October Term, 1993

BARCLAYS BANK PLC,

*Petitioner,*

vs.

FRANCHISE TAX BOARD,  
An Agency of the State of California,

*Respondent.*

On Writ Of Certiorari To The Court Of  
Appeal Of The State Of California  
In And For The Third Appellate District

BRIEF OF THE CONFEDERATION OF  
BRITISH INDUSTRY AS AMICUS CURIAE  
IN SUPPORT OF THE PETITIONER

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**BRIEF OF THE CONFEDERATION OF  
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**INTEREST OF AMICUS CURIAE**

The Confederation of British Industry ("CBI") is an independent, non-party political body organized in the United Kingdom. Its members include industrial, commercial, and public sector companies; employer organizations and trade associations that represent individual manufacturing industries; and commercial associations. CBI represents, directly and indirectly, more than 250,000 public and private companies and more than 200 trade associations, employer

organizations and commercial associations. CBI's members employ more than 10 million people.

Many of CBI's members do business in the United States or own subsidiaries that do business in the United States. In 1990, United Kingdom business accounted for almost 27 percent of the \$403.735 billion in direct foreign investment in the United States, or \$108.055 billion. *Statistical Abstract of the United States*, 12th ed., Government Printing Office (1992). Thus CBI, on behalf of its members, has a substantial interest in state taxation of U.K. companies and their affiliates. State use of unitary taxation on a worldwide basis ("worldwide combined reporting") has a direct and adverse impact on those members of CBI that do business in the United States or have affiliates that do so.

CBI prizes, and its members have a very strong interest in maintaining, positive economic relationships between the United Kingdom and the United States. Worldwide combined reporting is fundamentally destructive of foreign investment in the United States and of broader trade relationships between the United States and other nations, including the United Kingdom. For these reasons, CBI has for many years actively opposed the use of worldwide combined reporting by some States (including California) and has sought to eliminate the negative practical effects – including multiple taxation and excessive and discriminatory compliance burdens – which worldwide combined reporting imposes on foreign

multinationals.<sup>1</sup> Through this brief, CBI seeks to draw the Court's attention to the enormous problems created by worldwide combined reporting for U.K. and other foreign-based corporate groups.

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#### SUMMARY OF ARGUMENT

The United States has a longstanding policy to promote free trade and encourage foreign investment. Adoption of the arm's length method of taxation has been a part of that policy. Worldwide combined reporting discourages foreign investment in jurisdictions that impose it.<sup>2</sup> Worldwide combined reporting acts as a disincentive to investment primarily in three ways. First, because it is incompatible with the method used by all nations of the world to allocate income, it leads inevitably to double taxation. Second, worldwide combined reporting subjects foreign multinationals to extraordinary compliance burdens. The fact that these burdens are not imposed by the arm's length, separate accounting method is a major reason that separate accounting was adopted as, and continues to be, the international standard for the division of income. Finally, worldwide combined reporting introduces uncertainty, inimical to sound business planning.

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<sup>1</sup> The terms "foreign multinational" and "foreign-based multinational" are used herein to refer to a group of corporations that are ultimately controlled by a parent company resident in a foreign country and owned predominantly by non-U.S. citizens.

<sup>2</sup> Hereafter, a jurisdiction imposing worldwide combined reporting will be referred to as a "WWCR jurisdiction."

Because it discourages investment, worldwide combined reporting is directly at odds with United States policy. It has no place in the international sphere.

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## ARGUMENT

### I. INTRODUCTION

A major goal of United States foreign and economic policy has been and continues to be to promote the free international flow of capital and technology and to increase direct foreign investment in the United States. The Advisory Commission on Intergovernmental Relations described the benefits of international trade in the following terms:

[International] capital investments and income flows contribute significantly to increasing worldwide standards of living. The capital importing or host country benefits from the use of foreign capital in its production processes because the resulting higher capital-to-labor ratios can increase productivity and raise real earnings. The capital exporting country benefits from the rate of return that can be earned on capital employed abroad.

*State Taxation of Multinational Corporations, Study by the Advisory Commission on Intergovernmental Relations* (Nov. 1982). As early as 1964, the United States government expressed its desire to make evident to the world that the United States welcomes foreign investment. See *Report to the President of the United States from the Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United*

*States Corporations Operating Abroad*, Government Printing Office (1964).

From a business perspective, three things act as major *disincentives* to investment: (i) a risk of double taxation; (ii) high compliance burdens; and (iii) uncertainty of treatment. Worldwide combined reporting creates all three. Because it deters foreign investment, worldwide combined reporting frustrates United States policy and prevents the Nation from speaking with one voice. This is unconstitutional. See *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979); *Container Corp. of Am. v. Franchise Tax Board*, 463 U.S. 159 (1983).

### II. BECAUSE IT CONFLICTS WITH THE INTERNATIONAL STANDARD, WORLDWIDE COMBINED REPORTING CAUSES DOUBLE TAXATION.

#### A. Worldwide Combined Reporting is Fundamentally Different from Separate Accounting, the International Standard.

More than 60 years ago, the nations of the world adopted a standard method to divide the income of multinational businesses. That method is arm's length, separate entity accounting.

The basic theory of separate accounting is that only two countries have jurisdiction to tax income: the source country (the country in which income arises)<sup>3</sup> and the residence country (the country of domicile of the taxpayer). The right of the source country to tax income

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<sup>3</sup> As a general rule, income is deemed to "arise" where the income-generating activity takes place.

arising therein generally is accepted as primary to the right of the residence country to tax its domiciliaries. Even if a source nation chooses not to impose a tax, the income nevertheless is considered subject to the taxing jurisdiction of that nation, and no other nation (with the exception of the residence country) has the right to tax it.

Under separate accounting, each legal entity (or subdivision thereof, such as a branch) is treated as a separate taxpayer to which taxing jurisdiction applies separately. Jurisdiction of a country to tax any particular legal entity generally does not imply jurisdiction to tax related entities (or other subdivisions). The income and deductions of each legal entity are calculated separately.

Separate entity treatment is applicable regardless of the degree of relationship between affiliates in a group of corporations. However, source nations customarily reserve the right to examine individual *transactions* occurring between related entities (or branches) to determine whether they have been carried out on a basis which realistically reflects what would have occurred had the transaction been between unrelated parties dealing at "arm's length." Where it is found that the transaction was not carried out on an "arm's length" basis, tax administrators may make a deemed adjustment of the terms of the transaction for tax purposes, so as to reflect what the terms would have been had the transaction been at "arm's length."<sup>4</sup> Underlying this right is the principle

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<sup>4</sup> The Internal Revenue Service's authority for this adjustment is found in Section 482 of the Internal Revenue Code. The United Kingdom grants the Inland Revenue similar power in Section 770 of Taxes Act 1988.

that income realized on transactions governed by the marketplace is true economic income.

Separate accounting gives taxing pre-eminence to the jurisdiction of the source nation to tax. The residence country carries the burden of eliminating double taxation on the income of its domiciliaries that is subject to tax by another nation, either by granting a credit against its own tax for the source country tax or by permitting a deduction for the income subject to the source country tax.

Under separate accounting, the tax base (the measure of income to which the tax rate is applied) of a foreign multinational in a particular country includes only the profits arising in that country, less the deductions incurred in that country and allowed by that country's law. This approach ensures that taxation reflects actual economic performance in the marketplace in the relevant jurisdiction and also accords with basic business principles.

In contrast, worldwide combined reporting does not respect the separate legal existence of entities. It requires aggregation of the income and deductions of all entities, wherever located in the world, which California deems to be members of a "unitary group." California then applies a mechanistic apportionment formula to allocate to the California taxpayer entity a proportion of the worldwide profits of all the entities in the group.

California determines its share of the group's worldwide income by multiplying that income by a fraction equal to the average of three factors: property, payroll,

and sales (receipts).<sup>5</sup> The numerator of each factor is the unitary group's California property, payroll, or sales, and the denominator is the group's worldwide property, payroll, or sales.<sup>6</sup>

Worldwide combined reporting does not, and by its very nature cannot, take into account differences in profitability. Income is divided according to the monetary value of payroll, property, and sales located in the WWCR jurisdiction, regardless of the actual return derived therein. As described by the United States Assistant Secretary of Treasury Laurence N. Woodworth:

Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tantamount to taxation by a state government of the foreign income of a foreign corporation.

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<sup>5</sup> California recently amended its formula to double-weight the sales factor for most taxpayers. Cal. Rev. and Tax. Code § 25128.

<sup>6</sup> The factors used by those states that use formulary apportionment vary widely. While most use some combination of payroll, property, or sales, they do not weight the factors equally. The rules for determining when a given item (such as a sale) should be attributed to a taxing jurisdiction (and therefore included in the numerator of the factor) also vary greatly. See 1 *State Tax Guide, All States* (CCH) ¶ 10-110.

Hearings before the Senate Com. on Foreign Relations, 95th Cong., 1st Sess., 34 (1977).

Thus, the tax base under worldwide combined reporting is computed by (i) aggregating all profits derived from around the world (as computed under the accounting principles of the WWCR jurisdiction), (ii) subtracting the expenses incurred worldwide that are allowed by the law of the WWCR jurisdiction, and (iii) multiplying the result by the apportionment percentage.

Separate accounting and worldwide combined reporting fundamentally conflict.

**B. Because Separate Accounting Takes Differences In Profitability Into Account and Worldwide Combined Reporting Does Not, the Interaction of the Two Systems Naturally Results In Multiple Taxation.**

The basic objective of devising rules to allocate taxing capacity between different jurisdictions where cross-border trade and investment occur is to ensure both that each nation obtains its fair share of tax and that taxpayers are not subjected to double taxation. The arm's length separate accounting principle was devised and adopted by the United States, the United Kingdom, and other nations to achieve this result. It is the agreed international standard. Its application by fiscal authorities enables double taxation to be avoided. California's application of worldwide combined reporting is incompatible and makes exposure to multiple taxation inevitable.

Separate accounting, by focusing on the actual results of transactions in each jurisdiction, automatically takes

into account differing economic conditions in different source nations. For example, if a multinational enterprise generates the same gross receipts in two countries, but because of differing labor or property costs has lower expenses in one country than in the other, the separate accounting method would reflect the fact that there is more net income in one country than in the other.

Worldwide combined reporting, on the other hand, assigns the group's global income based on the dollar value of property and the dollar amount of payroll and sales in the WWCR jurisdiction. It ignores the differing "rates of return" in different economies. Therefore, where rates of return differ, overlap is inevitable.

It is undeniable that differences in market conditions exist in the world. They result from different labor and property costs, tax rates, other costs imposed on companies by governments including environmental regulation, currency exchange regulations, worker safety and administrative compliance, and a host of other variables.<sup>7</sup> Double taxation is the natural and inevitable result of the use of these incompatible systems.

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<sup>7</sup> The United States in general and California in particular tend to be high cost, low rate-of-return jurisdictions. Payroll and property costs are higher in the United States than in many other nations. See *International Economic Report of the President*, Government Printing Office (Jan. 1977). California, a leader in environmental regulation, causes industries to internalize costs that they would not bear directly in other countries. Moreover, California-style factor apportionment is inherently unfair. By its very nature, a factor formula will attribute the highest profit to countries which have the highest factor values, i.e., rich nations. For this reason alone, worldwide combined reporting could never be accepted on a global basis.

The problem of double taxation is especially severe if the entity operating in the WWCR jurisdiction incurs a loss. Separate accounting would permit the entity to report this loss for tax purposes. Under worldwide combined reporting, if the entity were part of an overall group which realized a profit, the worldwide combined reporting jurisdiction would allocate to itself some of that overall profit. Because the separate accounting jurisdictions in which the profits arose would also source to themselves and tax 100 percent of the profits, the multinational enterprise would pay a double tax.

Because double taxation reduces an enterprise's after-tax return from an investment, the high likelihood of double taxation will discourage an enterprise from investing in WWCR jurisdictions. The disincentive is even greater because worldwide combined reporting will not respect a loss incurred in the jurisdiction. An enterprise otherwise willing to operate at a loss for an initial period to establish itself in a new market faces the deterrent of having to pay tax on the profits of established profitable affiliates elsewhere in the world despite the local loss.

The deterrent is real. As a representative of the United States Department of State noted:

Foreign governments have informed us that, "The (unitary tax) method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." In their view a unitary tax constitutes ". . . a serious obstacle to the further development of our trade and investment relationships." (Note

signed by the Ambassadors of fourteen of our major trading partners). There have also been calls for retaliation.

Added to this are the statements from foreign business organizations like the Keidanren, which represents over 800 Japanese corporations: "Unitary taxation is the single most serious deterrent to new investment by Japanese enterprises in some states of the United States." The French Patronat, which represents a wide range of the biggest French industries with investment in the United States, described the unitary taxation method in a demarche to our Ambassador in Paris as ". . . not suited to the reality nor to the development of foreign investment, particularly between industrialized countries."

State government officials have also criticized the effects of unitary taxation. The unitary basis of taxation ". . . is contrary to the long established traditional spirit of welcoming foreign investment in the United States . . . We urge those states which have the law to repeal it." (News release of the American States Offices Association, whose members represent 21 states' offices and port authorities in Japan, 12/15/83).

Statement by Allen Wallis (Under Secretary of State for Economic Affairs) Concerning the Chairman's Working Group Report, taken from the Final Report of the Worldwide Unitary Taxation Working Group (August 1984).

### **III. WORLDWIDE COMBINED REPORTING IMPOSES EXCESSIVE COMPLIANCE BURDENS. THESE BURDENS DETER INVESTMENT.**

Businesses necessarily take compliance costs into account in deciding whether to invest in a particular

location. The costs of complying with worldwide combined reporting are excessive, and act as a deterrent to investment.

As described above, separate accounting respects the separate legal existence of entities, and taxes only the profits arising in the taxing jurisdiction. Reporting under separate accounting, therefore, generally requires foreign corporations to report information only on the operations of the entity actually doing business in the jurisdiction.

Worldwide combined reporting, in contrast, requires aggregation of the worldwide income of all entities that are members of a "unitary group", whether or not those entities have any presence or carry on operations in the WWCR jurisdiction. Accordingly, compliance with worldwide combined reporting requires the gathering and reporting of worldwide information for every foreign corporation in the group, not just those doing business in the WWCR jurisdiction. This information must be supplied by those foreign corporations.

Moreover, as noted above, worldwide combined reporting requires that the tax base be determined by computing income under the accounting principles of the WWCR jurisdiction, and by subtracting only those deductions allowed by the law of the WWCR jurisdiction. Reports also must be in English and in U.S. dollars. This is extremely burdensome in practice.

Each country has its own accounting rules, for both financial and tax accounting. An entity doing business in a country typically keeps its accounts using local language and observing local legal and accounting principles. Under worldwide combined reporting, a foreign multinational must

"convert" the accounts of each of its foreign affiliates from the various local rules into U.S. accounting principles and U.S. tax accounting rules. In practice, such "conversion" is impossible without the documentation from which the original reports were created. For example, because depreciation allowances differ under different accounting procedures, a French company would have to add back to its income its French depreciation deduction and then subtract out its WWCR jurisdiction depreciation deduction. To do this, the company would have to know (in dollars) the original cost of the depreciable property and the depreciation deductions already taken. The same is true of many other deductions, such as the bad debt reserve. See Roy E. Crawford, *Supreme Court Should Grant Certiorari in Barclays – Even if Clinton Sides with California*, 60 Tax Notes 1503 (Sept. 13, 1993).<sup>8</sup>

Thus, in practical terms, to comply fully with worldwide combined reporting a foreign multinational would have to keep a separate set of books for each foreign corporation using the accounting rules of each WWCR jurisdiction in which any member of the group operates.<sup>9</sup>

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<sup>8</sup> Financial accounting information, even when in U.S. GAAP, is not the same as tax accounting. The California trial court found in this case that using financial accounting information for foreign affiliates led to "inaccurate" income tax results. Appendix A to the Petition for Certiorari, No. 92-1384, at 33. Thus, a foreign corporation cannot use its financial accounts to prepare tax returns.

<sup>9</sup> Benjamin Miller, on the legal staff of the California Franchise Tax Board, has acknowledged that:

Actual adjustments to income, to be completely precise, would require the preparation of a separate set

The deterrent this creates for businesses considering investment in a WWCR jurisdiction easily can be envisioned. For example, assume a foreign multinational that does business in 30 different nations establishes a subsidiary in a WWCR jurisdiction. To file the subsidiary's tax return, the foreign multinational must set up a separate bookkeeping system in each of its 30 different operations which will keep records from those 30 operations in English, in U.S. dollars, and using U.S. accounting principles.

In addition, currency translation introduces particularly burdensome complications. Because currency exchange rates fluctuate over the course of a year, a simple translation of bottom-line amounts into U.S. dollars does not express accurately the dollar equivalent of income earned by different subsidiaries in different currencies during the year. Some sort of contemporaneous translation is necessary, and this must cover translation of each of the thousands (perhaps millions) of transactions engaged in by the subsidiaries over the course of the year.<sup>10</sup>

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of books and records on a California tax basis. This is administratively infeasible.

Benjamin F. Miller, *Worldwide Unitary Combination: The California Practice*, in *The State Corporate Income Tax*, 132, 156 (Charles E. McLure, Jr., ed., 1984).

<sup>10</sup> The California regulations provide for either an end-of-year exchange rate or a simple average exchange rate. Cal. Code Reg., Title 18, § 25137-6. Neither of these is completely accurate. One problem is that each currency creates its own separate economic world, with its own monetary conditions, inflation rate, and interest rates. Comparing profitability between two territories with different currencies is necessarily inaccurate.

Further, it may be not even be possible for U.S. subsidiaries of foreign-based companies to obtain the required information. A U.S. subsidiary may be unable to convince its foreign parent to develop the data needed to comply with the worldwide method, especially because the method is contrary to the internationally accepted method. Moreover, the foreign parent may be prohibited by foreign law from disclosing the information, for instance in relation to defense contracts with its own government.<sup>11</sup>

The problems compound when a foreign multinational group does business in numerous countries, each with its own currency and its own accounting standards. For a foreign multinational, such as the petitioner here, with more than 98 percent of its business overseas, the cost of complying with a state taxing system like this one is out of all proportion to the profit it can derive from business in the state.<sup>12</sup>

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<sup>11</sup> See *Capitol Industries-EMI, Inc. v. Bennett*, 681 F.2d 1107 (9th Cir. 1982), in which the taxpayer argued that it could not disclose information requested by California because the information was confidential under the United Kingdom's Official Secrets Act.

<sup>12</sup> This is not a hypothetical cost. The trial court in this case found the costs to establish a compliance system were \$5 million to set up and \$2 million annually to maintain. Similarly, in its brief in *Franchise Tax Board v. Imperial Chemical Industries PLC*, Dkt. No. 88-1400, Imperial estimated that its annual cost to establish and maintain the required accounting system was £ 2 million, an amount that exceeded the total amount of franchise tax assessed by California over a ten-year period.

It has been urged that these compliance costs are only the indirect costs of doing business overseas: a foreign taxpayer must expect to comply with the rules of the jurisdiction in which it does business, and foreign taxpayers suffer only because foreign nations do something different.<sup>13</sup>

This argument is fallacious. All nations, including the United States, have espoused separate accounting, in part because it avoids the massive compliance burdens of worldwide combined reporting. Worldwide combined reporting simply could not work as the global standard. If worldwide combined reporting were adopted by every nation in the world, every company in a unitary group would be forced to keep a set of books in the language, currency, and accounting rules of every nation in which any member of the group did business. For example, if a multinational group had 60 subsidiaries doing business in 60 different nations,<sup>14</sup> each subsidiary would have to keep 60 sets of records, for a total of 3,600 sets of records. The group's worldwide profits would quickly be devoured in accounting fees and compliance costs. Costs would increase even further if the group had more than one subsidiary or branch operating in a jurisdiction.<sup>15</sup>

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<sup>13</sup> This was essentially the position of the California Court of Appeal in its second opinion. See Appendix D to the Petition for Certiorari, No. 92-1384.

<sup>14</sup> Petitioner Barclays in this case had more than 220 subsidiaries doing business in 60 nations.

<sup>15</sup> Furthermore, if nations were to adopt worldwide combined reporting, each would undoubtedly vary the factors of the apportionment formula so as to allocate more income to that nation. This would work to the disadvantage of the United

Separate accounting is the only possible method for global use. Worldwide combined reporting is not just a "different" method, but an incompatible method that was rejected by nations as unworkable. It has no place in the international arena.

A business facing the complete revamping of its accounting systems, and the creation of new group data gathering and reporting systems at exorbitant cost, will be deterred from making an investment in a WWCR jurisdiction. The United States' policy of encouraging foreign investment is undermined by state use of worldwide combined reporting.

#### **IV. WORLDWIDE COMBINED REPORTING INCREASES THE LEVEL OF UNCERTAINTY, AND THEREBY DETERS INVESTMENT.**

Governments, both foreign and the United States, have recognized the need for a sound international tax structure to foster international free trade and investment by providing business certainty. The arm's length separate accounting standard is the foundation of the resultant accord. Experience has reinforced its soundness in principle and practice.

The networks of international tax treaties give practical effect to the arm's length standard on a bilateral basis. These treaties create mechanisms for the treaty partners to resolve questions of taxing jurisdiction at the level of

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States, the world's largest trading nation. This Court must strike down worldwide combined reporting now, to prevent its spread.

the particular taxpayer. Treaties also typically contain a "mutual agreement" procedure to protect taxpayers who believe that the actions of one or both of the treaty partners might result in double taxation. The taxpayers may present their case to the competent authority (the governmental body charged with administrating the treaty) of the treaty partner of which the taxpayer is a resident or national, to resolve the conflict by mutual agreement with the other treaty partner. In some cases, countries may run simultaneous audits of a taxpayer, to ensure that transfer pricing is carried out on the agreed arm's length basis.

Such mechanisms are predicated upon the arm's length separate accounting standard and are unavailable to jurisdictions imposing worldwide combined reporting. Because worldwide combined reporting rests on a different theory from separate accounting, differences cannot be reconciled by adjusting the income or expenses arising from particular transactions. Thus, the double taxation that will almost certainly occur cannot be so relieved.

Worldwide combined reporting also introduces uncertainty in two additional ways. First, because there are no objective guidelines for determining when an enterprise will be deemed "unitary," an enterprise will not know whether a WWCR jurisdiction will seek to subject it to worldwide combined reporting. Further, if an enterprise is deemed to be unitary by a WWCR jurisdiction, such as California, its tax liability in California will depend upon its income, property, payroll and sales not only in California but wherever it does business. Such variables will be incapable of accurate estimation in the course of the everyday decision-making process. Moreover, should the enterprise thereafter wish to invest in

another nation, it would have to consider not only the cost and return of that investment in its own right, but also its potential effect on its tax bill in the WWCR jurisdiction.

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### CONCLUSION

Worldwide combined reporting, such as the California system at issue in this case, interferes with the United States' longstanding policy of promoting free trade and encouraging foreign investment. It discourages investment by creating a high risk of double taxation, causing uncertainty in taxation, and imposing excessive compliance burdens. It is incompatible with the international standard for taxing multinational enterprises agreed upon by the United States and other sovereign nations. It must not be allowed to stand.

Respectfully submitted,

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